The Quest for Efficiency in the Public Sector: Economists Versus Dr. Pangloss

(or why conservative economists are not nearly conservative enough)

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The end of a Congress is not the place for heavy arguments and it is no part of my intention today to overload you with weighty reflections on what has passed during the last few days, nor indeed to burden your already taxed intellects with new theories or new facts about anything at all. The end of a congress may, however, be an appropriate place to amuse, titillate or irritate. I shall try to irritate you—possibly I shall raise a wry smile or two but basically I want to annoy. I shall try to do so by putting a set of dilemmas to you, each of which will, I hope, make you thoroughly uncomfortable.

As economists, we all—or nearly all—subscribe to the fundamental postulate of human action that individuals are expected utility maximisers. This, coupled with the assumption that individual tastes vary and the further assumption that compensated demand curves have negative price elasticities, leads to nearly all the important propositions that economists have to make about the real world—whether they are being normative or positive (or simply fudging the difference between the two). For example, the positive theory of exchange uses the assumptions I have just mentioned to predict that there will be only one price for each economic good. Any variance in prices will be explained by the presence of transaction, transport, etc costs. Since these are real social costs, we do not consider such a situation as a market failure. On the contrary, the market is doing just the job it should. How does this happen? It happens because prior decisions have also been taken about the market institutions that enable trade to take place: the definition and enforcement of private property entitlements, the law of contract, conventional ideas of decent behavior, and so on. These institutional arrangements can similarly be seen as the product of individual

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maximisation and bargaining: private property rights, for example, will not be established when the expectation is that enforcement costs, etc. will exceed the gains from trade and the orderly conduct of affairs. Put less strongly, individuals will not choose to change existing arrangements unless those seeing a benefit therefrom can also compensate those who anticipate a loss. It is, therefore, not just our theory of processes *within* markets that depends on utility maximising subject to constraints; it is our theories of political action, family behaviour, public or private bureaucracy, and our theories of the choice of allocative institution (market or state) that also depend on the same behaviour-generating postulate.

Economic efficiency or, as it is sometimes called, Pareto-efficiency (the two terms are synonymous), is defined as an arrangement from which no change can be made that does not impose uncompensated harms on someone. This is indeed our only concept of full efficiency. It does not incidentally imply *consumer* sovereignty, but the sovereignty of *all* individuals. It therefore follows, I suggest, that, since at any moment in time our positive theory of exchange tells us that all genuine gains from trade will have been exhausted, then at every moment of time there will be an *efficient* allocation of resources. This will be true of gains from deals done *within* a constitutional and institutional context and it is also true of the chosen (or existing) constitutional and institutional context itself. It is true of so-called market activities. It is true also of nonmarket activities. It is also true of public sector activities. For were it not so, and unexploited net social gains existed, then it cannot be the case that individuals are expected utility maximisers. They may, of course, regret consequences they did not foresee. But, at the time, what *was*, was *efficient*. They may also, of course, regard the constitutional context as unfair, unfree or unjust, so that, for example, the powerless and poor have no means to bribe the powerful and rich. But that is a question of distribution, not efficiency. To be logically consistent, then, we must, I suggest, accept that at any moment in time all is for the best (efficiency wise) otherwise it would have paid someone to incur costs persuading others to agree to change it, to incur costs identifying and compensating those who lose, to incur costs of enforcing any contracts thus made. Turning specifically to the topic of our congress, it follows therefore, that the public sector too is always efficient. And so it appears that the quest for efficiency in the public sector is an *empty* quest—not because the public sector can *never*, *inherently*, be efficient (as some of us seem to have argued here), but because it is *always* efficient. Economists must therefore be Panglossians. The size, scope and composition of the public sector in all countries must represent an economically efficient allocation. And that has to be as true of the USSR as it must be of HongKong.

I am not, of course, suggesting that all—or even most—institutional changes that do take place are Pareto-efficient moves. They nearly always

involve uncompensated harms and may even result in a less efficient resultant state of affairs. But it does not follow that putting the change into reverse will necessarily improve things, for the reverse change is itself costly (it may even be more costly than the original change) and meanwhile society may well have changed in important ways not previously accounted for. So there is an assymetry here: absence of change, according to Dr. Pangloss, implies that all is for the best; the presence of change *may* but only "may" imply that things are going to be for the better.

Recall the words that Voltaire put into Dr. Pangloss' mouth:

"Il est démontré, disait-il, que les choses ne peuvent être autrement; car tout étant fait pour une fin, tout est nécessairement pour la meilleure fin. Remarquez bien que les nez ont été faits pour porter des lunettes; aussi avons-nous des lunettes. Les jambes sont visiblement instituées pour être chaussées, et nous avons des chausses. . . . par conséquent, ceux qui ont avancé que tout est bien ont dit une sottise; il fallait dire que tout est au mieux."

Also sprach Dr. Pangloss; and while few economists subscribe to so all-pervading an optimism about the current state of any society, many—especially good price theorists—are indeed prone to the view that the theory of exchange implies—at least as far as *efficiency* is concerned—that things actually are for the best and that the private sector (or for that matter, though few price theorists would ever say as much, the public sector) is at all times and in all places Pareto-efficient. After all, were it not, it would have been changed: gainers would have bribed losers from any change in the composition, scale or organisation of the public (or private) sector, or in the balance between public and private, and Pareto-efficient moves to Pareto-efficient states would be made. If they are not, so the argument will go, then all must be for the best (really one should, of course, say *a* best), for the costs of making the change, of overcoming inertias, bribing bureaucrats, or meeting whatever other transaction costs might exist, must—as evidenced by behavior—be too large or too uncertain relative to benefits (which may themselves also of course be too uncertain).

You might object that the means available to a society for effecting change are needlessly cumbersome, costly and imperfect and that they lead to extremely poor revelations of people's preferences. But, as I have argued, the same Panglossian argument applies here too: even constitutional and institutional changes are costly; and to ignore such costs is to advocate Pareto-inefficient constitutions and institutions. Absence of constitutional or institutional change, or of any change in the procedures by which decisions are reached, is behavioral evidence for their efficiency whether the society in question is best characterised as feudal, capitalist, socialist, or anything else. Optimal institutional structures and optimal preference revelation are not going to be *perfect*, for an efficient constitutional and institutional arrangement will normally entail the presence of residual costs of decision making, bargaining and transacting in the everyday world. These are genuine opportunity costs like any other opportunity cost. Most conservative economists are therefore far too radical: their presumption that merely the market is efficient is not enough. The public sector is efficient too. The political system is efficient. *Everything* is efficient. Everything is wonderful!

Economists are naturally unhappy with Dr. Pangloss' conservatism and nonscientific tautology, whether on social or methodological grounds, or both. Candide too had his doubts. Yet it does have one signal virtue of a methodological type: in trying to account for the social phenomena we observe it compels us to ask the question "why does something happen or why does a particular arrangement exist—it has to be efficient for *something* or *someone?*": a question that has led to remarkable developments in the positive economics of politics, bureaucracy, the family and a host of untraditional spheres for the application of economic analysis. Moreover, to cast the Panglossian view aside does seem to require one to ignore (that is treat as zero) *some* social costs (in particular, transaction costs) and hence involve one in the fallacy of the free lunch—again an anathema to all good price theorists. How then can we escape? For it looks as though we economists are all—and always have been—redundant as moralists, welfarists and experts in the means of enhancing efficiency.

Escaping Dr. Pangloss' Clutches—Conservative Radical Style

One time-honoured manner of escape from the enchantments of Dr. Pangloss is to retain (conservatively) the individualistic postulates as both the underpinnings of behavioural models and the ideological basis for identifying "welfare" and changes in it, and to seek to promote change (perhaps radically) through *persuasion*. This view is founded on the proposition that economists know some things better than others know them; in particular, that economists have a comparative advantage in identifying Pareto-efficient states and Pareto-efficient moves. The possibility is thereby opened up that absence of change is not itself evident of the efficiency of the current state of things; it is merely the result of failure of gainers (and losers) to perceive the net advantages of change and also to devise appropriate means of ensuring the acceptability of any change. How many cost-benefit analyses of public sector activity, for example, press beyond the computation of net benefits to the detailed identification of losers from the change, the size of their losses, and means by which they may be compensated sufficiently to accept the change? (It must be said that all too frequently even economists

fail to address themselves to this second type of question which accounts, I conjecture, for the failure of so many results of cost-benefit analysis to have been acted upon).

Into this category of persuasion falls an immense range of economic policy advice: marginal cost pricing for nationalised industry; vouchers for education; redistribution in cash rather than kind; removal of price controls; reliance on markets for resource allocation. Intellectual activity here consists in the invention, reinvention, or resurrection of policy means that are alleged to lead to improved efficiency in the public (or private) sector, where the means proposed may be rules, mechanisms or behavioural constraints. Yet, while economists may succeed in persuading one another of the value of such things (or at least suceed in persuading fellow-members of a particular school of economics) they often fail dismally to persuade anyone else.

One set of reasons for this may, of course, be that efficiency is but one of the moral objectives that societies should seek and that it may conflict with others. But, even in the quest for efficiency itself, it may be that economists are giving unpersuasive advice. Efficient pricing rules, for example, are not only subject to the problems of second best, there are a set of even more fundamental issues relating, as our former president Jack Wiseman has so often told us, to the very notion of opportunity cost: in particular its evanescent and subjective nature as the perception of the most highly valued alternative course of action at the moment of decision in a highly uncertain world.

Or consider the application of a fundamental theorem of welfare economics that, provided certain conditions were met, a market will not only produce a Pareto-efficient allocation but, provided the government can determine an appropriate distribution of purchasing power in the community, it can even produce a Pareto-efficient allocation that the government may prefer on distributional grounds. This argument is not, of course, based on any Panglossian considerations.

We know that the circumstances required for this fundamental theorem to hold are extremely demanding and are not in practice met. Nonetheless, entire armies of economists devote their attention to trying to persuade the community that efficiency would be enhanced by returning substantial areas of the public sector to the market place. This sometimes involves going to quite extraordinary lengths. For example, I can think of no society that even *approximates* the formal theoretical conditions for Pareto-efficiency in its health service markets, yet this has not inhibited many economists on the one hand from attributing all the apparent ills of our health services to the interference of the state nor, on the other, from confidently predicting substantial welfare improvements from effecting such a shift. The truth is that in health, as in many other areas, we do not know enough to advocate sweeping reforms based on general theories asserted to be true under only highly restrictive circumstances. At least Dr. Pangloss was *modest* in his policy recommendations (indeed one could scarcely be more modest!) whereas our reformers, whether of the left or the right, typically erect more policy edifices than theory or evidence can usually support.

Or take, alternatively, the widespread arguments one hears about the *behavioural* response of managers, bureaucrats, producers and consumers to changes in the constraints they confront. Much of this literature asserts that public sector management and bureaucracy will be less efficient than management and bureaucracy in the private sector. At their naivest, those who recommend policy based upon such theorising fall into the trap of assuming that the *only* efficiency-generating source of behaviour is the pursuit of wealth, which must surely be one of the naivest—not to say amateur—psychological theories around. Even at their more sophisticated the new theories of managerial, bureaucratic and political behaviour are still too infant and too little exposed to systematic empirical test for us to assert their logical implications as empirically well-founded and for us really to be able to assert their beneficence as confidently as some do.

As it happens I *do* believe that economists have a comparative advantage in the invention, reinvention and resurrection of policy instruments that may identify newly perceived opportunities for increased efficiency. But I would conjecture that we are most valid when we are empirically most specific and most persuasive when we are most modest in the extent of change proposed. The bold claims from right or left for the efficiency of markets or collectivism are simply not persuasively sustainable.

Escaping Dr. Pangloss' Clutches—Radical Radical Style

The other time-honoured manner of escape for those still wanting to be normative is to be radical both about the basic postulates as well as about the promotion of social change. For example, one may reject the essentially static concept of Pareto-efficiency. Instead one may advocate competition as an agent of efficiency via the process of discovery and invention. This particularly German/Austrian way of looking at things emphasises process (and progress) so that efficiency is, as it were, a *process of becoming* rather than a *state* that can be usefully described in terms of the familiar marginal conditions (even if they include uncertainty, externality and intertemporal trading).

It is not clear to me, however, that "competition" is so easily measured that one can say that it is "more" here and "less" there (is a race between 500 more competitive than one between two?), nor is it clear to me that the types of competition observed in the public sector are systematically more or less conducive to dynamic efficiency than those observed in, say, the tomato market. Moreover, although I am ignorant of any applications of this sort of analysis to specific problems in the public sector (they doubtless exist), I am quite confident that such applications are neither so numerous nor their empirical results so widely accepted in the economics fraternity that they can escape the difficulty noted above with the static theories of managerial, bureaucratic and political behaviour. They may be promising beginnings, but they are scarcely an adequate basis for persuasive and specific policy advice. Indeed, all the arguments with which I am familiar in this genre are entirely *a priori* and disturbingly general. They may be the intellectual stuff of which revolutions get made but they offer little assistance in the quest for efficiency in the public sector (or any other). Revolutions, of course, are omelettes made by breaking eggs and have nothing to do with economic efficiency.

An alternative escape route is to question the maximand. The traditional individualistic framework provides both the basis for the utility maximising analysis of behaviour (whether in groups or individually) and also the basis for the social welfare function: the rockets of both positive and normative economics are fired from the same launching pad. It is, therefore, unsurprising that Dr. Pangloss poses a problem mainly for economists who use neoclassical individualism as their *modus operandi.* But for those who adopt more proximate maximands, say, a target for steel output, or who view the business of health services as increasing the health of populations, or the business of schools as keeping teachers in employment, the problem disappears. Similarly, those enamoured of a "merit want" approach to many of the activities in the public sector (particularly, perhaps, those in the social services—including health, education and housing) cut the Panglossian knot with a single bold sweep of a sword. It is not surprising, of course, that economists who adopt this strategy attract the contempt of the methodological individualists. But they do (at least) have the virtue of using a methodology that gets them decisively out of Dr. Pangloss' clutches and that, moreover, enables them to relate much more easily to policy customers unencumbered with one awkward—and hard to communicate—part of the utilitarian baggage of neoclassicism.

Should We Take Dr. Pangloss Seriously?

I think we should. It is common to label *prima facie* departures from Pareto-efficiency in the market as "market failures". Setting aside adverse distributional affects (which may be important, but are not directly relevant to efficiency questions) the usual sources of failure that are adduced include phenomena like monopoly (natural or otherwise), externalities, and failure to establish and enforce exchangeable property rights. Source of "government failure" can be similarly categorised. The standard microeconomic approach to such issues is to identify potential efficiency gains. We do not assert that the optimal degree of pollution is necessarily zero, but that it is determined by an equality between the marginal benefit of reduced pollution and the marginal cost of effecting a reduction. We do not assert that all monopoly must be prohibited, but contrast, say, the loss of scale economies that may be incurred by breaking monopolies with the net gains in consumer and producer surplusses that may result. We do not assert that all entitlements and contracts should be clearly defined in law, be legally binding and coercively enforced, but balance expected gains against prospective costs of enforcement, etc.

An economic Dr. Pangloss does therefore have a point. For if all individuals are utility maximisers, and if we believe in the theory of exchange, and if Pareto-efficiency is defined as an allocation from which no move can be made without imposing an uncompensated reduction in utility somewhere in the community, then all costs and benefits will have been considered. Trades not made; monopolies not broken; institutions not invented and used; voting systems not used; collective or individual arrangements not adopted; points not attained on contract curves; and so on, must all have not been engaged in or attained because they were judged too costly. Market, or government, failure, according to Dr. Pangloss, is *apparent* not real: it is the product of imperfectly specified optimality conditions, in particular, conditions that omit some relevant marginal (or total) social costs.

It is surprising that economists have not taken Dr. Pangloss more seriously. I detect—though it would be invidious to name names—that economists using methodological individualism who come from market economies tend *implicitly* to adopt a Panglossian view of the *market*. But scarcely anyone takes this view of the public sector. Instead, there is an assymetry: market allocations are presumptively efficient and public sector allocations presumptively inefficient. This leads to an assymetry in the locations of burdens of proof: economists advocating, for example, a transfer of activity from the private to the public sector are required to demonstrate the *a priori* and empirical reasons for so doing (there being no general presumption that such a transfer of activity will yield a Pareto-improvement). By contrast, economists advocating a transfer of activity from the public sector to the private are rarely required by their fellow professionals to do other than rehearse some general *a priori* arguments (for in this case there is a shared presumption about the Pareto-efficiency of such a transfer of activity). Of course, outside the economics fraternity no such presumptions may exist.

What I should like to suggest is that we should take Dr. Pangloss more seriously and argue that the burden of proof lies on him who advocates *any* change; that the general presumption is that *whatever* is, is Pareto-efficient; at its weakest, that the quest for efficiency in the public sector is neither more nor less problematic than the quest for efficiency in the private sector.

For those who are uncomfortable with the Darwinian and conservative implications of Panglossian methodology, there seem to be four tenable escape routes, of which two have been described. The first is to argue that the economist's role in the quest for efficiency is entrepreneurial: the invention, reinvention or resurrection of allocative mechanisms; and the provision of information about the incidence of the costs of change and how such losses may be compensated—at least for those with sufficient political power to sabotage any reform. The test of their success in identifying potential Pareto improvements is whether their entrepreneurial inventions get adopted. And they have no business to complain when their inventions are rejected, for when they *are* rejected, the inventions were plainly failures. Since economic advice is nearly always rejected, this is an unpromising escape route. The second escape route is to reject the individualistic basis of the concept of Pareto-efficiency in favour of more limited and specific objectives possibly linked with a specific recognition that one is seeking least cost methods of meeting particular levels of merit wants. Since nearly everyone disapproves of the merit good approach, this too is an unpromising escape route. I leave it to each of you to select your own route from these two unpromising prospects.

There are, however, the other two escape routes—though I doubt whether any of you will find them even as appealing as the previous two (which is why I have given them no attention hitherto):

One is to argue that most of what economists deplore in the public sector is the result of mistakes: collective policies were originally adopted in high expectation of success and were even, perhaps, Pareto-efficient in terms of expected utility. But the hopes are dashed and economists pursuing the quest for public sector efficiency are there to document the failure, explain why it occurred and show how to avoid it in the future. The trouble with this view is that the so-called mistakes seem to persist beyond any reasonable learning period. For example, what public regulatory policy has been more consistently decried by economists for at least 50 years than rent controls. There are dozens of articles allegedly demonstrating their inefficiency. They are a classic case study in nearly every textbook. Moreover they have also been demonstrated to have regressive distributive consequences. I cannot think of a single economic voice in their support. Yet rent controls persist and they persist in nearly every developed country in the world. Yet if they were *really* inefficient, their removal would have enabled a net gain to accrue to everyone, landlords and tenants. Ergo, they are either efficient or individuals are not utility maximisers. So, while mistakes may happen from time to time there is something in the Panglossian view that they do not happen very often. There seems little mileage in this way out.

The final escape route is simply to *ignore* the basic problem of inconsistency to which Pangloss is really drawing our attention. After all, we have got along for many years with the inconsistencies between, say, macroeconomics and microeconomics. One could simply sweep the problem under the carpet. However, I don't think this is a route many of you would choose, for even if an ultimately completely consistent economic theory of human action can never be attained, we are surely bound to seek it. Whether we are going to be Panglossian or anti-Panglossian we should at least seek consistency, for Dr. Pangloss is surely right in drawing our attention to the inconsistencies in much current practice: whether it be the inconsistency of accounting for some opportunity costs but not all; or the inconsistency of assuming that individuals simultaneously realise all achievable mutual gains from trade while leaving some unexploited; or the inconsistency of assuming that individuals choose rationally *within* institutional contexts but choose their institutions irrationally; or the inconsistency of having differential presumptions about the degree of efficiency in the public sector relative to the private. Inconsistency is a great enemy. As Voltaire would have said (though not, I think, of inconsistency) *Ecr. l'inf!*

Resumé

Le Docteur PANGLOSS soutient que, puisque tous les individus maximisent toujours l'utilité attendue, tous les gains que l'on attend du commerce sont réalisés ex-ante, sous réserve de toutes les contraintes de caractère réel. De plus il soutient que toutes les institutions mises en place par les collectivités pour des transactions d'affaires connaîtront le maximum d'efficacité souhaitée étant entendu aussi qu'elles sont soumises aux contraintes inhérentes aux ressources naturelles et qu'elles savent que les individus maximiseront l'utilité qu'ils en attendent quel que soit le système de réglementation et d'institutions que l'on adopte. En conséquence, tout est toujours pour le mieux, ex-ante, et il n'y a pas de place pour des économistes réformateurs qui chercheraient par exemple à changer l'équilibre entre secteurs publics et privés pour des raisons d'efficacité. Mais ont-ils vraiment une place après tout? Nous suggérons quatre possibilités restreintes qui semblent être consistantes avec la logique à la fois constante et pénible du Docteur Pangloss.